The case for shareholder-based capitalism

Policy Exchange

Geoffrey Owen

Foreword by Rt Hon Mel Stride MP

The case for shareholder-based capitalism

Geoffrey Owen

Foreword by Rt Hon Mel Stride MP

Policy Exchange is the UK's leading think tank. We are an independent, non-partisan educational charity whose mission is to develop and promote new policy ideas that will deliver better public services, a stronger society and a more dynamic economy.

Policy Exchange is committed to an evidence-based approach to policy development and retains copyright and full editorial control over all its written research. We work in partnership with academics and other experts and commission major studies involving thorough empirical research of alternative policy outcomes. We believe that the policy experience of other countries offers important lessons for government in the UK. We also believe that government has much to learn from business and the voluntary sector.

Registered charity no: 1096300.

Trustees
Alexander Downer, Pamela Dow, Andrew Feldman, David Harding, Patricia Hodgson, Greta Jones, Andrew Law, Charlotte Metcalf, David Ord, Roger Orf, Andrew Roberts, Robert Rosenkranz, William Salomon, Peter Wall, Simon Wolfson, Nigel Wright.

About the Author

Geoffrey Owen is Head of Industrial Policy at Policy Exchange. The larger part of his career has been spent at the Financial Times, where he was Deputy Editor from 1973 to 1980 and Editor from 1981 to 1990. He was knighted in 1989. Among his other achievements, he is a Visiting Professor of Practice at the LSE, and he is the author of three books – "The rise and fall of great companies: Courtaulds and the reshaping of the man-made fibres industry", "Industry in the USA" and "From Empire to Europe: the decline and revival of British industry since the second world war." He is the co-author, with Michael Hopkins, of "Science, the State, and the City: Britain's struggle to succeed in biotechnology"

© Policy Exchange 2021
Published by
Policy Exchange, 8 – 10 Great George Street, Westminster, London SW1P 3AE

www.policyexchange.org.uk

ISBN: 978-1-913459-89-5

Contents

About the Author 2
Foreword 5
Executive summary 6
Introduction 8
Background 10
Purpose 15
Short-termism 20
Inequality 24
Conclusion 29

Foreword

Rt Hon Mel Stride MP
Chair, Treasury Select Committee

As this paper points out, there is nothing new to hostility towards capitalism. In every generation, the merits of a dynamic, free-market economy need to be defended, explained and its virtues expounded.

As we have seen throughout the COVID-19 pandemic, most notably in relation to vaccines, the animal spirits that capitalism can unleash are able to deliver extraordinary innovation and human achievement, even in the face of extraordinary challenges.

Nevertheless, British capitalism, and the shareholder-based capitalism it exemplifies, has come under increasing critique.

This paper questions the lines of argument advanced by those critics and examines in detail the case for the version of capitalism that drives the British economy and has turned the United Kingdom into one of the most dynamic and globalised economic success stories in the world.

Sir Geoffrey addresses some of the pressing questions and criticisms facing modern capitalism, including the purpose of modern companies, how they reconcile their obligations to stakeholders and shareholders, the accusation of short-termism often levelled at British and American capitalism and finally how inequality relates to pressing questions of shareholder compensation and executive pay.

These questions can often invite polemical responses, and Sir Geoffrey's paper is impressive in that it takes clear positions while presenting a nuanced and considered portrayal of other arguments. In that sense, this paper is a valuable intervention on a live discussion and a valuable reference for policy-makers from all sides. One would expect nothing less from such. distinguished former editor of the Financial Times.

I would in particular highlight the initial section which charts the evolution of modern capitalism from some of the key debates in the 1920s, through the evolution of the idea of Corporate Social Responsibility (CSR) to more recent arguments about financial regulation and accounting practices, crystalised in the passing of Dodd-Frank and Sarbanes-Oxley in the United States. Sir Geoffrey manages to explain these issues with detail and concision, offering something for both the lay-reader and policymaker.

The other discussion to which I would draw the reader's particular attention is the thoughtful and considered reflection on the problem of 'short-termism'. This paper suggests that there is no silver bullet here, and that there may be many unintended consequences to changes in our current framework. As in other sections, the paper rightly calls policymakers to think hard about the systems they would seek to regulate.

This is a timely and comprehensive paper and I commend it to all who are interested in the future of our economy and the role of shareholder-based capitalism in the 21st century.

Executive summary

There is nothing new about hostility to capitalism, but in recent years the capitalist system, especially in the form that it has taken in the US and the UK, has come under attack from a broader set of critics. Much of this criticism centres on the role played by the large, investor-owned corporations that dominate the economies of most advanced industrial nations. Too many of these corporations are said to behave in a way that causes or aggravates some of society's most serious problems, such as environmental degradation and increasing inequality.

The source of this behaviour, the argument continues, lies in the doctrine of shareholder primacy, the notion that managers of public corporations must prioritise the interests of shareholders above those of other groups that are affected by their decisions. The single-minded pursuit of profit, and a higher share price, is said to encourage companies to do bad things. The dominant influence of shareholders is also blamed for promoting short-termism. The solution to these problems, according to this view, lies in downgrading the influence of shareholders and encouraging or compelling companies to adopt a social purpose that goes beyond making profits.

The purpose of this paper is to examine whether these criticisms of the capitalist system are valid, and whether the proposed reforms are desirable.

The paper looks first at the historical background, showing how the doctrine of shareholder primacy came to the fore in the US and the UK in the 1980s and 1990s, and how that doctrine has come to be challenged by supporters of stakeholder capitalism. A debate is now in progress, on both sides of the Atlantic, pitting defenders of shareholder primacy against a range of pro-stakeholder advocates.

The paper discusses three of the central issues in this debate: what the purpose of companies should be; short-termism; and inequality.

On the first, the paper argues that companies are right to respond to changing public expectations – for example, about protecting the environment – among consumers, employees and investors. Because of these pressures, many companies are moving in a stakeholder-friendly direction and paying closer attention to social issues. However, that does not require abandoning the principle of shareholder accountability. Moves to insulate companies from shareholder pressure would remove an important source of dynamism in the market economy.

On short-termism the paper questions how far the threat of takeover or an attack from a corporate raider leads companies to focus on short-term profit improvement. What matters is that companies should be able

to articulate and defend their long-term strategy. While some raiders may see a temporary fall in the share price as an opportunity to make a quick profit, others see it as an indication that the strategy is not working, and that the company needs to change direction, or its management.

The escalation in executive pay is often seen as a partial cause of rising inequality, but it is less important than other factors, principally technological change and globalisation, which have widened the gap between high-skilled and low-skilled people. Rewards for top managers have increased markedly since the 1980s, mainly because of the shift to performance-based pay linked to the share price, but the incentive effect of this shift has been, on balance, good for corporate performance.

Shareholder-based capitalism should not be seen either as a major contributor to the world's ills or as a perfect system that cannot be improved. The flaws in the system are not so fundamental or so irremediable as to justify a reordering of company law. Shareholder accountability and the focus on long-term shareholder value provide an effective means by which the wealth of society can be increased.

Introduction

> *The corporation "is the creator of wealth, the source of employment, the deliverer of new technologies…At the same time, it is the source of inequality, deprivation and environmental degradation, and the problems are getting worse".*[1]
>
> *"We have created a system in which many of the world's companies believe that it is their moral duty to do nothing for the public good".*[2]

There is nothing new about anti-capitalist sentiment, but in the last few years the capitalist system, especially in the form that it has taken in the US and the UK, has come under attack from a broader set of critics, many of whom have no sympathy for anything that smacks of socialism. Such people want to preserve and strengthen the market economy but believe that the dysfunctional aspects of capitalism urgently need to be corrected.

At the heart of many of these criticisms is the belief that big, investor-owned companies, which dominate the economies of advanced industrial nations, are run in a way that causes or aggravates some of the world's most serious problems. A particular target for attack is the doctrine of shareholder primacy, the notion that managers of public companies must prioritise the interests of shareholders over those of other groups that are affected by their decisions, including employees, local communities and society at large.

The single-minded pursuit of profit, and a higher share price, is said to encourage companies to do bad things. It also leads to extreme unfairness in the way rewards are distributed. Shareholders and senior executives can do well, sometimes extravagantly well, at the expense of others who depend directly or indirectly on what the company does. This causes resentment among the disadvantaged groups and a general distrust of the capitalist system.

The malign influence of shareholders is also blamed for what is widely seen as a chronic weakness in Anglo-American capitalism: short-termism. Companies, under pressure to keep their investors happy and the share price up, are said to focus on near-term profit improvement at the expense of investments which will only pay off in the long term. If the share price falls in response to a temporary drop in profits, the company may find itself vulnerable to the threat of take-over, or an attack from a corporate raider.

How valid are these criticisms? Would companies make a bigger contribution to social welfare, and inflict less damage on the world, if

1. Colin Mayer, Prosperity: better business makes the greater good, Oxford 2018, p1.
2. Rebecca Henderson, Reimagining capitalism in a world on fire: how business can save the world, Penguin 2020.

the influence of shareholders was reduced? If long-term shareholder value is abandoned as the principal measure of a company's performance, what should replace it? These are the questions with which this paper is concerned.

It begins with a review of the historical background, showing how the doctrine of shareholder primacy gained ground in the US and the UK in the 1980s and 1990s, and the emergence of alternative theories that would give more weight to non-shareholder interests. It then looks at three issues that are central to the current debate: whether companies should have a purpose that goes beyond making profits; short-termism; and inequality.

The concluding section argues that the case for radical change in corporate governance and corporate law is weak. Shareholder-based capitalism remains the most effective means of promoting economic growth, innovation and prosperity. Governments and companies need to work together to promote a better understanding of the capitalist system.

Background

The debate about whether companies should focus on serving shareholders or on broader social objectives has a long history. In the 1920s there was a famous dialogue about the duties of directors between two US academics, Merrick Dodd and Adolf Berle. The former argued for a stakeholder view of the corporation, with directors encouraged to consider the interests of non-shareholder constituencies, while the latter saw shareholders as an essential constraint on managerial power.[3]

At that time most large British and American corporations were owned by dispersed investors who had neither the power nor the incentive to intervene in managerial decisions, and that continued to be the case in the years following the Second World War. The period between the 1950s and the 1970s is often described as the era of managerial capitalism, in which directors of companies were largely free from shareholder interference. The prevailing view among business leaders was that they should balance the interests of all their various stakeholders. This meant, in effect, that they were free to run their companies in whatever way they thought fit; some of them sought to make their companies bigger, but not necessarily more profitable.

There was also growing interest during this period in the concept of corporate social responsibility (CSR), whereby companies were encouraged to engage in philanthropic or socially beneficial activities that were unrelated to their business and had no direct link to profitability. This was based on the idea of corporate citizenship, the notion that society had given companies an informal "licence to operate" which obliged them not to pursue purely selfish ends but to contribute positively to the well-being of society.[4]

It was the rise of CSR that prompted a famous intervention by Milton Friedman, one of America's most distinguished economists. In an article published by the New York Times in 1970 Friedman insisted that business had one and only one social responsibility – to increase its profits.[5] In a free-enterprise, private property system, Friedman wrote, a corporate executive is an employee of the owners of the business, the shareholders. "That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom".

Friedman did not object to a company spending money on socially beneficial activities if they were related to its business. For example, it might want to improve the governance of its local community or to upgrade

3. Jennfer G. Hill, Then and now: Professor Berle and the unpredictable shareholder, ECGI Law Working Paper 163/2010 September 2010.
4. Davd Henderson, Misguided virtue, false notions of corporate social responsibility, Institute of Economic Affairs, 2001.
5. Milton Friedman, New York Times, September 13, 1970.

the quality of local schools; such spending might enhance the company's reputation and make it easier to attract well-qualified employees. His main point was that managers should not use shareholders' money to support activities that did not contribute to the growth of the company's profits.

During the 1980s and 1990s the Friedman doctrine came to be widely accepted as a guide to corporate decision-making. This was not due directly to Friedman's influence (although his views were shared by many other economists), but rather to a change in the business environment. Thanks to the worldwide reduction in tariffs and the rise of new competitors – notably from Japan, followed by other East Asian countries – many companies found themselves exposed to intense competitive pressure. A management style that had been acceptable in the 1950s and 1960s gave way to a new focus on cost cutting and efficiency improvement.[6]

These policies were reinforced by changes in the financial markets. In response to legislation which promoted the growth of collective savings vehicles such as pension funds and mutual funds, the ownership of publicly traded companies shifted from private investors to institutional shareholders. These new owners were willing and able to take a close interest in the companies in which they invested; they had the power to demand changes in management or strategy when performance was poor. Listed companies were increasingly judged on their ability to maximise shareholder value; those that failed to do so were at risk of being taken over by more successful rivals.

In the US another threat came from raiders such as T. Boone Pickens and from specialists in leveraged buyouts such as Kohlberg Kravis Roberts.[7] In the UK a successful exponent of the hostile takeover technique was Hanson Trust, built up by James Hanson and Gordon White. One of its larger acquisitions was that of Imperial Group, formerly Imperial Tobacco, which had diversified from tobacco into a range of consumer-related operations; after the takeover Hanson sold off most of the non-tobacco businesses.

The tighter focus on profitability brought about substantial changes in industrial structure and in corporate strategy; several of the over-diversified conglomerates that had flourished in the earlier post war years were dismantled, a process that improved efficiency and generated large gains for shareholders. But there were other forces at work during this period which pointed in a different direction.

The fashion for corporate social responsibility was running strongly, as new social problems came into greater prominence. The threat of environmental damage was a cause for concern, among governments and in the public at large; incidents such as the Exxon Valdez oil spill off the coast of Alaska in 1989 drew attention to what was seen as corporate irresponsibility in this area. It was one of several issues taken up by increasingly influential non-governmental organisations (NGOs). Some of them targeted the employment practices of multinational companies, highlighting poor working conditions in their overseas factories. Companies had to be more sensitive to reputational risk, and to abandon

6. Bengt Holmstrom and Steven N. Kaplan, The state of US corporate governance: what's right and what's wrong? NBER Working Paper 9613, April 2003.
7. George P. Baker and George Davd Smith, The new financial capitalists, Cambridge 1998.

or modify policies that might attract the attention of NGOs.

Although these attacks were not for the most part motivated by an anti-capitalist ideology, some critics believed that part of the problem stemmed from the single-minded focus on the part of public companies on profit. A corrective which gained some support in the 1990s was the introduction of "triple bottom line" reporting, whereby companies were encouraged to report each year on their environmental record and their contribution to social welfare as well as their financial results.[8]

There was also growing interest in replacing the shareholder-centric approach to corporate governance with a stakeholder-based system, in which the interests of non-shareholder groups would be given more weight. In the UK this thinking was influenced in part by admiration of the German approach to corporate governance, which gave employee representatives seats on company boards and put less emphasis on shareholder primacy.

The stakeholder concept was reflected in a review of UK corporate law which took place at the end of the 1990s and was the basis for the Companies Act of 2006.[9] This Act required directors, in promoting the success of their company for the benefit of its members (that is, its shareholders), to "have regard" to the interests of employees, the need to foster business relationships with suppliers, customers and others, and the impact of the company's operations on the community and the environment. How these non-shareholder responsibilities should be fulfilled was not spelt out.

Stakeholder ideas were also gaining ground in the US. During the 1980s, in response to the wave of hostile takeovers which threatened to cause job losses in firms that were under attack, several state governments introduced so-called constituency statutes, which gave companies incorporated in that state the freedom to reject a takeover offer if it would damage stakeholder interests.[10] However, the state of Delaware, which had long been the pace-setter in corporate law – it is where most of the largest US corporations are incorporated - remained committed to shareholder primacy.

The number of hostile takeovers declined in the 1990s, partly because the most obvious targets had been picked off, and partly because companies had made themselves less vulnerable to attack. However, the role of shareholders in corporate governance remained a much-debated issue, all the more so in the light of the scandals that took place during the dot-com boom at the end of the 1990s. The collapse of American companies such as Enron and WorldCom exposed the failure of shareholders (and boards of directors) to prevent executives from using illegal or questionable methods to keep the share price up and to conceal the true financial state of the business. The consequence was the Sarbanes-Oxley Act of 2002, which introduced new rules to improve the accuracy of financial reporting and stiffer penalties for criminal activity.

A few years later came the world financial crisis of 2008. One of the precipitating factors was the attempt by banks and other financial institutions to boost their profits through the sale of complex, new-fangled

8. The phrase "triple bottom line" was invented in 1994 by John Elkington, founder of a consultancy called SustainAbility.
9. John Plender, Going off the rails: global capital and the crisis of legitimacy, Wiley 2003, pp267-268.
10. Brett McDonnell, Corporate constituency statutes and employee governance, Michigan Law Review 1227 (2004)

securities, without disclosing the risks associated with these investments. The crisis was followed by another set of reforms, the Dodd-Frank Act of 2010, which focused mainly on tighter regulation of the financial services industry.

The wider consequence of the financial crash, and the deep recession that followed, was to damage confidence in capitalism (as well as giving ammunition to long-time enemies of the system) and to stimulate demands for radical change. 2011 saw the emergence in New York of a protest movement, Occupy Wall Street, which denounced the evils of capitalism. Similar protests took place in London.

At the political level these issues were taken up by the left wing of the Democratic Party, led by a self-declared socialist, Senator Bernie Sanders. Sanders ran unsuccessfully for the Democratic presidential nomination in 2016 and 2020, but he did well enough to show that there was wide support in the party, not for overthrowing capitalism, but for curbing its excesses and making the system fairer.

Senator Elizabeth Warren, one of the party's candidates for the 2020 presidential nomination, proposed what she called the Accountable Capitalism Act, "to end the grip of shareholder value maximisation and return to the era when American corporations produced broad-based growth that helped workers and shareholders alike". The Act provided for mandatory representation for employees on company boards and curbs on share buybacks, which she said were a means of channelling more wealth to shareholders and senior executives.

These proposals did not form part of the Democratic Party's programme for the 2020 election and have not been taken up by President Biden. However, the idea that the system was biased in favour of shareholders to the detriment of other stakeholders was gaining support across the political spectrum. At the same time big companies were coming under attack for other reasons, most importantly for the damage they were accused of doing to the environment.

Public expectations about the role of business in society were changing. In January 2018 Larry Fink, chairman of BlackRock, one of America's largest institutional investors, urged companies to a give a higher priority to non-shareholder interests. Society, he wrote in his annual letter to chief executives, "is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance but also show how it makes a positive contribution to society."[11]

A more surprising intervention came a few months later when the Business Roundtable (BRT), an association of leading US chief executives, issued a statement on corporate purpose which appeared to downgrade the interests of shareholders in favour of a broader commitment to generate long term value for all stakeholders. The statement had a mixed reception. It was strongly criticised by the Council of Institutional Investors, and some saw it as no more than virtue signalling, which would make no practical difference to the way companies behaved. Nevertheless, the

11. A sense of purpose, Larry Fink, chairman of BlackRock, letter to CEOs, January 17, 2018

statement has helped to stimulate a vigorous debate about the purpose of companies, pitting defenders of shareholder primacy against a range of pro-stakeholder advocates in the business and investment communities, as well as in academia.

A similar debate has been taking place in the UK. As in the US, it has been driven in part by the belief that the world is facing serious social and economic problems, and that these problems will not be solved unless companies change their ways. There is also increasing support, especially but not only on the left, for the view that capitalism in its present form puts employees at a disadvantage vis-a-vis shareholders and senior executives, and that this cannot be corrected without a fundamental change in the system.[12]

The next three sections examine three of the central issues in the debate.

12. See, for example, Do dividends pay our pensions? A report from the Trades Union Congress, Common Wealth and the High Pay Centre, 2022.

Purpose

Corporate law as it now stands in the US and the UK is based on the principle that managers of public companies are accountable to shareholders. Shareholders are not normally involved in running the business, but they have the right to appoint and remove directors, to vote on major transactions such as mergers and takeovers, and to receive the "residual income" – that is, profit - after all other costs have been paid. The principal intermediary between managers and shareholders is the board of directors, which today is mostly made up of independent directors, not full-time employees of the company. Its task is to monitor the performance of the executives on behalf of shareholders and to make changes when necessary.

Most of the reforms in corporate law and corporate governance that have taken place in recent years, often in response to scandals, have been designed to strengthen the board of directors, to improve the flow of information from companies to shareholders, and to outlaw practices whereby executives enrich themselves at the shareholders' expense.

There have also been some moves by regulators to widen the responsibilities of companies to include non-shareholder interests. In the UK, as noted in the previous section, the 2006 Companies Act required directors of companies to pay more regard to other stakeholders, and this part of the Act, Section 172, has subsequently been strengthened. Companies are now required to explain in their annual reports how they had identified the views of stakeholders and how the information had influenced decision-making. However, these changes do not undermine the principle of shareholder primacy. When the interests of shareholders conflict with those of a stakeholder group, as for example when the company plans to close a loss-making factory, the shareholders take precedence.

To go further in a stakeholder direction, by giving non-shareholder groups equal weight to shareholders, runs into problems of accountability. If directors are answerable to a range of different groups which may well have conflicting objectives, how do they choose between them? Trying to balance these different interests is a recipe for compromise and confusion, which can only damage the company's efficiency.

Some of the same issues arise in relation to employee representation on boards of directors. This was one of the provisions in Senator Warren's Accountable Capitalism Act, and a similar suggestion was made by Theresa May when she became UK Prime Minister in 2016, although this proposal was later dropped. The model is Germany, where co-determination, with

workers represented on the supervisory board, has been in operation for many years. However, the German system has not been widely imitated.[13] For large companies which operate in several industries and several countries, different employee groups have different concerns and objectives; arriving at a collective decision which satisfies all of them may be an impossible task.

A larger question is whether shareholder primacy has contributed, not just to the neglect of non-shareholder groups, but to wider social ills. This is a theme which has been taken up in several recent critiques of the capitalist system, and it has had some influence among business leaders and investors. A prominent contributor is Rebecca Henderson, a Harvard professor. She starts from the position that the three greatest problems of our time are environmental degradation, economic inequality and institutional collapse. Business, she writes, must play an active part in finding solutions to these problems, instead of regarding them as "externalities" that can be left to government. This will only happen if business breaks away from the idea that the first mission of the firm is to maximise profits.[14]

If shareholder interests are to be downgraded in favour of broader social objectives, how is that shift to be brought about? In the US several state governments have introduced the concept of public benefit corporations (PBCs), whereby companies that incorporate in their state can choose to set out in their founding charter a social purpose that takes precedence over shareholder value. These companies are owned by shareholders, but they are under a legal obligation to abide by their stated purpose, and they cannot be sued for taking decisions which enhance public benefit at the expense of investors.

Some critics have questioned the value of the PBC concept, arguing that in most cases the statements of purpose are too vague and aspirational to be legally significant, or to serve as a guide to decision-making.[15] So far, most PBCs are private firms, although there have been suggestions that large, publicly listed corporations should be required to adopt PBC status.[16]

In the UK David Kershaw and Edmund Schuster at the London School of Economics have proposed a change in the law which would allow firms to establish what they call a zone of insulation against shareholder pressure.[17] Their proposal is built around the idea of purpose-driven companies, and the aim is to generate a more inclusive form of capitalism. Noting that UK corporate law is exceptional in its unique focus on shareholder value and power, the authors argue for a new approach to regulation which would allow greater optionality in the relationship between managers, shareholders and other stakeholders; this will often involve a demotion of shareholder interests.

A more radical change has been advocated by Colin Mayer, a professor at the Said Business School in Oxford.[18] He believes that the Friedman doctrine of shareholder primacy is fundamentally wrong, because it makes it difficult or impossible for companies to pursue any objectives other than

13. Simon Jager, Shakked Noy and Benjamin Schaefer, What does co-determination do? NBER Working Paper 28921. June 2021
14. Rebecca Henderson, Reimagining capitalism
15. Jill E. Fisch and Steven Davidoff Solomon, The "value" of a public benefit corporation, ECGI Law Working Paper No 585/2021 May 2021.
16. Leo Strine, Toward fair and sustainable capitalism, Harvard John M. Olin Discussion Paper No 1018, October 2019.
17. David Kershaw and Edmund Schuster, The purposive transformation of corporate law, ECGI Law Working Paper No 616/2021 April 2020.
18. Colin Mayer, Prosperity

those focused on financial goals. Remedying this mistake requires changes in company law that would oblige companies to give more weight to environmental and social concerns and to adopt a corporate purpose that goes beyond making profits.

Mayer's ideas were taken up by the British Academy, the UK's national academy for the humanities and social sciences, which in 2019-2021 conducted a series of conferences and workshops on the future of the corporation. In its final report the Academy reaffirmed Mayer's central message, that the social responsibility of business should not merely be to increase its profits, but rather "to create profitable solutions to the problems of people and planet, while not profiting from creating problems for either".[19] Every company should have a purpose, and the primacy of purpose as a guide to decision-making should be embodied in law. The report proposed a new wording for Section 172 of the Companies Act, replacing the primary obligation to shareholders with a requirement that directors must "act in a way that would be most likely to advance the purpose of the company".

In an article written for a US audience with two American co-authors, Mayer applauded the recent pro-stakeholder statement from the Business Round Table. He pointed out, however, that because of the power of shareholders there was no effective mechanism to encourage adherence to the principles set out in the statement; "the system is stacked against those who attempt to do so". The authors proposed a uniform federal mandate requiring large companies, those with annual revenues above $1bn, to become public benefit corporations.[20]

These proposals raise two questions. How far would a change in the law, downgrading shareholder primacy, increase the contribution that corporations make to social welfare?[21] What would be the impact of such a change on the way companies are run, and more generally on economic performance?

Some companies behave unethically, or in a way that harms society. Even the largest and most respected companies sometimes do bad things. One example was the "culture of concealment" at Boeing, which, according to a congressional inquiry, contributed to the two fatal crashes of the Boeing 737 in 2019. At a lower level the collapse of Persimmon, one of Britain's largest house builders, "laid bare a culture driven by greed," according to the Financial Times. The affair, the newspaper wrote, was "a sad indictment of capitalism at a time when companies are vowing there is more to the pursuit of shareholder value than just profit".[22]

Are misdeeds of this kind sufficiently widespread to justify a reordering of company law? Today's public companies, especially big companies, are fully aware of changing public expectations about how they should behave. They face a range of demands, some of them coming from government and some from non-governmental organisations, for action to combat social problems.

A new factor has been the involvement of investors in supporting these demands.[23] Since the early 2000s there has been a surge in what is

19. Policy & Practice for Purposeful Business, the final report of the Future of the Corporation programme, British Academy, 2021
20. Colin Mayer, Leo E Strine and Jaap Winter, The purpose of business is to solve problems of society, not to cause them, ProMarket, published as part of a collection of essays under the title "Milton Friedman 50 years later, a re-evaluation", Stigler Center, Booth School of Business, University of Chicago, November 2020.
21. Another approach, not discussed here, is to replace shareholder value as a corporate objective with shareholder welfare, which would require companies to identify and respond to shareholders' non-economic concerns. Oliver Hart and Luigi Zingales, Companies should maximise shareholder welfare not market value, Journal of Law, Finance and Economics 2 2017.
22. Financial Times, December 19, 2019.
23. For a study of how investors should respond to stakeholder concerns see What does stakeholder capitalism mean for investors? The Investor Forum and the Centre for Corporate Governance at London Business School, January 2022.

called ESG investing, focused on environmental, social and governance factors. Many of the big institutional investors, including BlackRock, have emphasised ESG in their investment policies, and there are also smaller, more specialised funds that concentrate on this topic.[24]

A notable example was the success of Engine No 1, a small ESG fund founded in 2020, in forcing Exxon Mobil, the oil company which had been widely regarded as a laggard on environmental issues, to change the composition of its board; three incumbent directors were replaced by newcomers who had expertise in environmental matters.[25] That success would not have been achieved if the activist had not been backed by large institutional investors.

Companies also have to take into account the views of employees, who have become increasingly vocal, not just in relation to issues such as climate change, but also in other areas. If companies want a loyal and committed workforce, they have to demonstrate that their values, and the principles that guide their decisions, are aligned with those of their employees.

In 2018 Google employees expressed concern over the company's plan to compete for a Department of Defence contract involving artificial intelligence; the objection was on the grounds that the technology could be used in ways that could lead to human rights violations. Google subsequently withdrew from the competition.

In responding to these pressures directors have to safeguard the interests of investors, but that requirement is not so binding as to force them to take "anti-social" decisions. Companies have a wide degree of discretion in deciding how to respond to demands from outside pressure groups.[26] They may well choose to do things which damage short-term shareholder value if they believe that it is in the company's best interests, and the reaction of shareholders can often be supportive.

In 2018, when Dick's Sporting Goods, a Pennsylvania-based retailer, decided to stop selling guns in some of its stores following a school shooting incident, it did so because the chief executive thought it was the right thing to do, irrespective of the financial consequences; there were fears that the company could lose a quarter of a billion dollars from the decision. As it turned out, sales grew in the stores where gun sales were discontinued, and when the policy was later extended to more stores, the company's share price rose.[27]

Neither senior executives nor shareholders believe that all decisions should be narrowly focused on profit. It is entirely possible, indeed desirable, for a company to have a purpose that is not directly related to shareholder value. When Sergey Brin and Larry Page founded Google, their aim was to build the best search engine; that was the goal that drove the growth of the business. In such cases profit can be seen as an outcome rather than an objective; some of the most successful companies have leaders who appear to be not much interested in shareholders, still less in day-to-day movements in the company's share price.

Many entrepreneurs, like Brin and Page, have ambitions to build

24. Not all investors are enthusiastic about these trends. Unilever, much admired for its commitment to sustainability and other social priorities, has recently been attacked by one of its larger shareholders for overstressing ESG factors to the detriment of shareholder value, Financial Times January 12, 2022,
25. Derek Brower and Ortenca Allaj, Engine No 1, the giant-killing hedge fund, has big plans, Financial Times, June 3, 2021.
26. Jill E. Fisch and Steven Davidoff Solomon, Should corporations have a purpose? ECGI Law Working Paper No 510/2020, March 2020.
27. This story is told in Fisch and Solomon, Should corporations have a purpose, drawing on Sarah Nassauer, How Dick's Sporting Goods decided to change its gun policy, Wall Street Journal, December 4, 2018.

companies that will benefit not only their investors and their employees, but also society at large. They do so by instilling in their employees a sense of purpose and a set of values through which they are motivated to work hard for the company's success. The reputation which the company builds up through its management practices may also affect attitudes among its suppliers and customers; they think well of the company and like doing business with it. Purpose in that sense is closely related to what the company does, and it is more likely to carry weight if it is specific and as far as possible measurable.

Hewlett-Packard is a company which during its heyday in the 1960s and 1970s enjoyed a stellar reputation for its prowess in innovation, for the quality of its products and for the way it treated its employees; it was seen as a role model for other Silicon Valley firms. It also provided its investors with a handsome return, but this was in no sense the principal driver of its success.[28]

Purpose does not have to be embodied in law, but it can be enforced through the market. "Customers who are attracted by a corporation's commitment to the welfare of its workers can sanction the corporation's lack of attention to working conditions in its supply chain by refusing to buy its products. Employees can sanction corporations that do not adhere to their environmental or social policies by working elsewhere".[29]

A stated purpose can be valuable, but it cannot be expected to last indefinitely. The dynamism of the free-market economy depends on competition between profit-making enterprises, each of which is seeking to create or extend a competitive advantage in its chosen line of business. As technology changes and new competitors emerge that advantage may be eroded. This is when shareholders can play an important role. They may see more clearly than managers of a long-established and successful business that change is needed. In some situations, this can involve the breakup of the company and the transfer of its assets to other owners who are better able to manage them profitably.

Most senior managers want their company to survive for a long time, but there are dangers in putting too much emphasis on longevity. Germany, where capital market pressure is less than in the US or the UK, has an industrial structure in which large, long-established companies, some of them controlled by families or foundations, play a leading role. While some of these companies are highly successful, there has been a lack of new entrants to challenge the incumbents, and this is often blamed on the conservatism of the German financial system.

To free companies from shareholder accountability, and hence from shareholder pressure, is to undermine one of the key features of the capitalist system. But is shareholder pressure sometime applied in ways that damage the system and reduce social welfare? A persistent criticism of Anglo-American capitalism is short termism, which is the subject of the next section.

28. David Packard, The HP Way, How Bill Hewlett and I built our company, HarperCollins 2006.
29. Fisch and Solomon, Should corporations have a purpose?

Short-termism

When Milton Friedman, in his 1970 article, argued that companies should make as much profit as possible, he was not suggesting that directors should focus on short-term profit, still less on the current share price. What matters, as several of Friedman's followers have emphasised, is long term shareholder value. Nevertheless, many commentators believe that, whatever Friedman may have intended, his doctrine has evolved into an obligation on companies to maximise profits at all times.

A leading proponent of this view is Martin Lipton, an influential New York lawyer who has often defended companies against what he sees as shareholder interference driven by short-term considerations. He believes that "short-termism and attacks by short-term financial activists significantly impede long-term economic prosperity."[30]

Lipton's argument is that public companies are over-preoccupied with the need to meet the expectations of shareholders in the short term; they fear that if their quarterly profits fall they may find themselves exposed to the threat of takeover, or to the unwelcome attention of an activist investor. In order to "meet the numbers" they will cut back on investment, for example in research and development or in workforce skills, that will only pay off in the long term. To avoid the tyranny of quarterly reporting, and to escape the other obligations that come with a stock exchange listing, companies may prefer to go private. This has contributed to the growth of private equity firms, which by acquiring public companies and removing them from the stock market can concentrate on improving their performance without having to worry about temporary fluctuations in profits.

Adoption of a long-term strategy is made more feasible, some argue, if the company has an anchor shareholder who is committed to the business and has no intention of selling its shares. In the US some newly formed technology firms, when they go public, do so with a shareholding structure that gives the founders a disproportionate share of the voting rights, and hence the ability to resist unwanted takeover bids. In the UK stock exchange rules have until recently restricted the use of dual class shares, but these rules were relaxed in 2021 to allow premium listed initial public offerings (IPOs) to have a voting structure of this kind, although dual class shares have to be discontinued after five years; the change was made to encourage firms to list their shares in London rather than New York.[31]

In the US companies have been able to use a range of stratagems which can frustrate hostile takeover bids. These include so-called poison

30. Martin Lipton, The New Paradigm: a roadmap for an implicit corporate governance partnership between corporations and investors to achieve sustainable long-term investment and growth, presented to World Economic Forum, August 2016.

31. Financial Times, July 5, 2021.

pills, which make it difficult or expensive for the would-be bidder to assemble enough shares to influence the outcome.[32] Some companies also have staggered boards, whereby directors are re-elected at different times, making it difficult for a bidder to remove the entire board at one time. The lack of such devices in the UK is often seen as a reason why British companies are more exposed to the takeover threat than their US counterparts.

Some economists have argued that short-termism is partly responsible for the UK's relatively low level of business investment in research and development, compared to other industrial countries.[33] They point to evidence that privately owned firms spend more on research than their publicly listed counterparts, although a recent study in the US casts doubt on this conclusion.[34] Another study suggests that the high level of merger and acquisition activity in the UK has contributed to short-termism, and does little to improve the long-term performance of businesses that are acquired.[35]

The wider economic consequences of short-termism have prompted governments take a close interest in the topic. In 2011 the British government commissioned a report from John Kay, a leading economist, on what might be done to encourage long-term thinking on the part of shareholders and company directors. The report concluded that the principal causes of short-termism were "the decline of trust and the misalignment of incentives throughout the equity investment chain".[36] The proposed remedies, most of which were accepted by the government, focused on improving relations between boards and shareholders, and encouraging the latter to engage more fully with their investee companies, focussing on strategic issues as well as questions of corporate governance. The report also recommended that companies should refrain from trying to manage investor expectations about short-term profits.

Yet despite extensive research the evidence for the belief that short-termism is causing economic damage is not conclusive. In the US the supposedly malign effect of short-termism is hard to square with the willingness of investors to support loss-making companies for many years in the belief that they will eventually generate good profits.[37] Amazon is a well-known example but many other technology- or science-based firms have benefited from long-term investor support during periods when they are reporting little if any profit and not much revenue.

In biotechnology, for example, America's highly developed capital markets, including early-stage angel investors and venture capitalists as well as public investors, have funded hundreds of innovative companies when there is no certainty that they will ever bring drugs to the market. In the energy field, investment in fracking technology involved long periods of negative cash flow for the entrepreneurs and firms engaged in it.[38]

Anxiety about quarterly reporting may also be overdone. An unexpected fall in quarterly profits may be seen by investors as an indication that the company's long-term strategy is not working. Excessive long termism, when companies continue to invest in businesses that have no future, can

32. The poison pill was invented by Martin Lipton in the 1980s. When the shares acquired by the bidder reach a certain level, the poison pill kicks in and existing shareholders are allowed to buy more shares at a discount.

33. See for example Richard Davies, Andrew G. Haldane, Mette Nielsen and Silvia Pezzini, Measuring the costs of short-termism, Journal of Financial Stability, Vol 12 June 2014.

34. Naomi Feldman et al, The long and the short of it: do public and private firms invest differently? Federal Reserve Board, 2018-068. Add names

35. Alan Hughes, Short-termism, impatient capital and finance for manufacturing innovation in the UK, Centre for Business Research, Cambridge University, Working Paper No 457, March 2014.

36. The Kay Review of UK equity markets and long-term decision making, Final Report, Department of Business, Innovation and Skills, July 2012.

37. Stock market short-termism's impact, Mark J. Roe, ECGI Law Working Paper, 426/2018. August 2020.

38. Steven N. Kaplan, Are US companies too short-term oriented? Some thoughts, Journal of Applied Corporate Finance, 30/4, 2018. The fracking story is told in The frackers, Gregory Zuckerman, 2013, and in The fracking revolution, John Golden and Hannah Wiseman, Emory Law Journal 64/4, January 2015.

be just as dangerous as short-termism.

As for the takeover threat, it is often argued that companies are too quick to give in to a hostile bid when the price offered is well in excess of what seems likely to be achieved in the near term. Yet if the management can present a plausible case that their strategy is correct and that the company will do better on its own, it can win sufficient support from shareholders to fight off the bid. This is what happened in 2014 when AstraZeneca, the British pharmaceutical company, resisted a takeover bid from Pfizer of the US. One newspaper commented, after Pfizer had withdrawn, that AstraZeneca's chairman and his colleagues should be congratulated for taking a clear decision on what was best for their company and displaying coolness under fire. "Few company boards manage to behave so robustly".[39]

Hostile takeovers have become less common in the last few years, and companies are now more likely to come under attack from activist investors, especially hedge funds, whose aim is not to take over the business but to engineer a change in strategy or management. Some of these attacks are driven by short-term considerations, for example to force the company to pay out more money to investors through dividends or share buybacks.[40] But activist hedge funds can also play a constructive role.

The most successful of these funds are ones which believe, after careful research, that a particular company is poorly led or is pursuing the wrong strategy.[41] Having acquired a small shareholding they inform the board of their proposals for change. In some cases, the proposals are accepted, and the company makes the changes that the hedge fund has asked for. In others there is resistance, and the activist may approach the large institutional investors for support. If that support is forthcoming, the company may be forced to give way. In these situations, the activist fund is in effect filling a corporate governance gap; many of the big institutional investors, with stakes in hundreds of companies, are reluctant to devote resources to the detailed study of particular firms.

Whether activist investors play a helpful or unhelpful role remains a matter of debate. What is certainly true is that in the US and the UK over the last thirty years financial markets have come to wield a bigger influence on the way companies are run. This is a process called financialisation, and it is often regarded as a negative element in the Anglo-American capitalist system.

In the introduction to his report on short-termism John Kay suggested that financialisation was partly responsible for the demise of two once successful British companies, ICI and GEC. In the 1990s these two companies sought to change direction, moving from an over-diversified business model to one in which they concentrated in areas where they possessed, or hoped to develop, a competitive advantage. At first these strategies were supported by most commentators and by shareholders, but both of them subsequently came to grief, in part because of over-ambitious acquisitions for which they probably paid too much.

Bad luck also played a part. GEC, which was renamed Marconi in

39. Guardian May 19, 2014,

40. John C. Coffee and Darius Palia, The wolf at the door: the impact of hedge fund activism on corporate governance, Centre for law and economic studies, Columbia University Working Paper 521, September 2015.

41. Ronald J Gilson and Jeffrey N. Gordon, The agency costs of agency capitalism: activist investors and the revaluation of governance rights, Working Paper 438, Centre for law and economic studies, Columbia University, March 2013.

1999, had focussed on telecommunications, a sector that experienced an extraordinary boom, linked to the arrival of the internet, in the second half of the 1990s. The collapse of the boom in the early 2000s put Marconi, in common with several other telecommunications firms, into serious financial difficulty from which it was unable to recover.

Both these companies made mistakes. Both of them were also motivated, in part, by the need to increase shareholder value. But it is not clear that their demise can be ascribed to short-termism. In commenting on the GEC/Marconi story the Financial Times pointed out that the outcome showed how difficult it was to reshape a company that had drifted into a strategic cul-de-sac. The lessons from the collapse, the newspaper wrote, included "a slapdash strategy, executed too fast and too expensively, too little day-to-day-management, and too complacent a board".[42]

Some companies, when their share price is under-performing, are tempted to do things which they think will impress shareholders in the short term – most obviously when they think a takeover bid may be imminent.[43] In these situations the role of the board is crucial. The board needs to be able to make an independent assessment and not to be over-reliant on the views of senior managers who are generally anxious to preserve the status quo. Some boards are not well equipped to perform this role; part-time independent directors generally have a limited understanding of the company's strategy. A board made up of better informed, well-resourced and highly motivated directors would be in a stronger position to defend the company against activist incursions.[44]

Strengthening the board and improvising its credibility with investors are better ways forward than any attempt to restrict what activist hedge funds can do or to make takeovers more difficult.

42. Financial Times, January 21, 2002.

43. Equally, an over-valued share price can cause companies to make bad decisions, as happened in the dot-com boom in the late 1990s, Mchael Jensen, Agency costs of overvalued equity, ECGI Fnance working paper No 38/2004.

44. Strengthening boards in this way has been suggested by two American academics. Ronald J. Gilson and Jeffrey N. Gordon, Board 3.0 – an introduction, The Business Lawyer, 74/2, Spring 2019

Inequality

Of all the explanations for why capitalism is unpopular, one that comes high on the list is executive pay. "Greed is good", said Gordon Gekko in the film Wall Street. For many people this remark summed up the mindset that took hold in the business and financial communities in the 1980s and 1990s. That period saw the start of an escalation in executive pay that has continued, with occasional interruptions, in subsequent decades. Top earnings in business and finance are widely thought to be not only excessive, but also, in many cases, unrelated to performance. They are also seen as a major cause of social and economic inequality.

In the UK, according to the High Pay Centre, the median chief executive officer of a FTSE 100 company was paid £2.69m in 2020, 86 times the median full-time worker; the ratio was more than twice what it had been in the 1990s. The highest paid chief executive in that year was Pascal Soriot at AstraZeneca, who received £15.45m. The comparable figures in the US are much higher; the average S & P 500 company CEO-to-worker pay ratio in 2020 was 299-to-1, compared to 21-to-I in 1965 and 61-to-1 in 1989.[45] The highest paid American CEO was Chad Richison of Paycom Software, who earned $211m.

How and why has this increase taken place, and how much has it contributed to inequality?

Since the 1980s the main drivers of rising inequality in the advanced industrial countries have been technological change and globalisation.[46] The former, including most importantly advances in information technology, has had the effect of eliminating many semi-skilled jobs, especially in manufacturing, and forcing displaced workers to find employment in less well-paid occupations, often in the services sector. At the same time globalisation has encouraged firms to outsource manufacturing operations to low-wage countries. These two trends, taken together, have widened the income gap between those people who have the skills and education to benefit from technological change and globalisation and those who have lesser qualifications, or none at all.

Another factor has been government policy. In the UK Margaret Thatcher's Conservative government (1979-1990) was a pro-capitalist, pro-competition administration which wanted the private sector to flourish with the least possible intervention from the state. This meant, among other things, lower taxes and other incentives to encourage entrepreneurs and to ensure that successful business leaders were richly rewarded. Obstacles that had held back the growth of profitable businesses, notably the power of the trade union movement, were removed or weakened. A

45. Lawrence Mishel and Jori Kandra, CEO pay has skyrocketed 1,322% since 1978, Economic Policy Institute, August 2021
46. Branko Milanovic, Global inequality. A new approach for the age of globalisation, Harvard University Press, 2016, ch 2

similar approach was followed in the US by the Reagan Administration, which held office from 1981 to 1989.[47] Deregulation, especially in the financial sector, was a high priority in both countries.

Alongside these developments was a new approach to how corporate executives were paid. As the priorities of companies shifted towards maximising shareholder wealth, new pay arrangements for senior managers were introduced, designed to align their incentives with those of shareholders. The most striking change was the replacement of straight salary with stock options and other share-based rewards, which came to represent an increasing proportion of senior executives' remuneration.

This approach to executive pay was welcomed by shareholders, since they shifted the thinking of boards towards increasing profits rather than building bigger empires. Profits did increase in the 1980s and 1990s, as did share prices; in companies that did well, senior managers benefited handsomely from share-based payment schemes. However, many of the stock option plans were poorly designed. Some companies manipulated the content and timing of their financial reports in order to push the share price up and make their stock options more valuable. Another practice which could result in very large pay-outs was the use of "golden parachutes" to compensate executives who might lose their jobs in the event of a takeover.

These excesses aroused a good deal of envy and resentment in the public at large. Executive pay became a hot political issue on both sides of the Atlantic. In the US the scandals that occurred during the dotcom boom of the late 1990s prompted extensive reforms of corporate governance, through the Sarbanes Oxley Act of 2002, which included new rules on executive pay. The next set of reforms came in 2010 with in the Dodd Frank Act. Two innovations were the "say on pay" scheme, whereby shareholders were given the right to hold a non-binding vote on the company's remuneration policy, and the requirement that companies should publish the ratio between the CEO's pay and that of the average worker.

In the UK the issue came to the fore in the early 1990s. Managers in some of the recently privatised public utilities were found to have been awarded stock options which, because of the low price at which their companies had been floated on the stock market, turned out to be extremely generous. The subsequent row prompted the establishment of a committee under Richard Greenbury, chairman of Marks & Spencer, whose report set out new guidelines for the design of share-based payment schemes.[48] One consequence of the Greenbury report was to encourage companies to replace stock options with Long Term Incentive Plans (LTIPs), through which the award of shares was tied to the executive's ability to meet a range of performance targets, usually measured over a three-year period.

The Greenbury report was the first of several government attempts to keep executive pay under control; they included, as in the US, a "say on pay" scheme and the requirement for companies to publish the ratio between chief executive pay and that of the average worker. The aim was

47. Frank Levy and Peter Temin, Inequality and institutions in 20th century America, NBER Working Paper 13106, May 2007.

48. Directors' remuneration: report of a study group chaired by Sir Richard Greenbury, July 1995.

to shame over-paying companies into greater restraint, although most of the shareholder votes that took place in subsequent years approved the company's remuneration policy.

These interventions, while they have caused some companies to cut back egregiously lucrative schemes, have done little to assuage the critics. In the US Lucian Bebchuk and Jesse Fried at the Harvard Law School have argued that excessively high pay has been due to managerial power, the ability of dominant chief executives to extract generous pay packages from complaisant boards of directors and remuneration committees. They recommended that shareholders should be involved directly in pay decisions.[49] Others have questioned this analysis, arguing that, while there have been abuses, boards of directors have generally done a good job in providing executives with incentives that encourage them to focus on long-term shareholder value.[50]

Another much-debated issue concerns share buybacks, which have been widely used in the US and on a lesser scale in the UK as a means of transferring cash to shareholders. Willam Lazonick, a professor at the University of Massachusetts, believes that companies use buybacks to push the share price up; by reducing the number of shares in circulation and increasing earnings per share, they make stock options more valuable. Another consequence, according to this writer, is to reduce the funds available for investment.[51] Others argue that buybacks are an entirely legitimate device, and more flexible than dividends, when companies' investment opportunities are low and they have surplus cash.[52]

In the UK concern over buybacks prompted the government in 2017 to commission an independent study of the matter. The subsequent report could find no evidence to suggest that share repurchases were being used systematically to hit earnings per share targets or were crowding out investment.[53]

A curb on share buybacks formed part of Senator Warren's proposed Accountable Capitalism Act and it remains a contested issue. The broader question is whether, as some critics believe, the focus on shareholder value, and the share price, as the determinant of executive pay is fundamentally wrong. The only possible solution, according to this view, is a reordering of managerial priorities along the lines suggested by Colin Mayer and others, with shareholder value downgraded as a guide to corporate decision-making.[54]

Yet the evidence suggests that, on balance, share-based remuneration has been an effective means of improving corporate performance. To support this case Alex Edmans, professor of finance at the London Business School, uses the story of Bart Becht, chairman of Reckitt Benckiser, a consumer goods company, who became the subject of widespread condemnation in 2019 when the company reported that his total remuneration in the previous year had amounted to £92m.[55]

Edmans pointed out that of the £92m only £5m consisted of compensation for what he had done in 2009, the rest coming from shares and options that he had received since 1999. "Not only did Bart have to

49. Lucian Bebchuk and Jesse Fried, Pay without performance: the unfulfilled promise of executive compensation, Harvard University Press, 2004.
50. Bengt Holmstrom, Pay without performance and the managerial power hypothesis: a comment, SSRN, May 2006.
51. William Lazonick, Profits without prosperity, Harvard Business Review, September 2014.
52. Alex Edmans, Grow the pie, Ch 7. See also Jesse M. Fried and Charles C. Y. Wang, Are buybacks really short-changing investment? Harvard Business Review, March-April 2018
53. Share repurchases, executive pay and investment, BEIS Research Paper No 2019/011. See also Lenore Palladino and Alex Edmans, Should the US rein in share buybacks? Financial Times December 10, 2018.
54. Deborah Hargreaves, Are chief executives overpaid? Polity Press 2019
55. Alex Edmans, Grow the pie Ch 5

work for a decade to earn his shares and options but that decade had to be an extremely successful one for them to be worth so much". The company had performed outstandingly well under Becht's leadership, with the share price rising from £7 to over £36, making it the fourth best performer in the FTSE 100. The company was also highly regarded for consistently developing new products which were better value and more convenient for consumers. Becht's contribution to the business was underlined when he announced his retirement from the company in 2011; the share price promptly fell by £1.8bn, nearly 20 times his 2010 pay.

Chief executives who have the ability and experience to run a large international company are hard to find. The job has become more complex and more demanding, in part because of the changing public expectations discussed earlier in this paper. Intense competition for these rare individuals is one of the factors that has made them more expensive. One American academic claims that high CEO pay is "part of the engine that has helped America develop so many world-class companies".[56]

There is certainly room for improvement in the way executive pay schemes are designed. A recent UK study has shown that schemes based on a company's relative performance compared to its competitors can lead to generous pay-outs when the company does well but are much less sensitive to periods of poor performance.[57] More generally, there is a strong case for making pay schemes simpler; some of them have such a wide range of performance criteria that the basis for the award is difficult for shareholders, and even the executive concerned, to understand. This applies particularly to LTIPs, and many companies are now replacing them with restricted shares; executives are awarded shares that cannot be vested for several years, usually five or seven, and do not depend on performance targets. This puts executives in a similar position to that of ordinary shareholders.[58]

As for the impact on inequality, the shift to share-based remuneration for senior executives is part of the story, and some weight should also be given to the weakening of trade union power.[59] However, executive pay is a much smaller contributor to inequality than the broader trends, including the decline in manufacturing, discussed at the start of this section.[60] The social and economic costs arising from these trends have promoted governments to search for effective remedies; the Johnson government's levelling-up agenda. Is one example.

There is also the separate but related question of how to protect employees from the "creative destruction" which is an inevitable part of the free-market, capitalist system. When a company is struck by an external shock, perhaps arising from international competition or a novel technology, employees, whose skills are usually tied to a single employer, are in a much worse position than shareholders, most of whom have a diversified investment portfolio. Jeffrey Gordon, a law professor at Columbia University, has suggested a social insurance scheme whereby governments would subsidise employers to provide their employees with access to lifelong re-training and re-education, so that they will be better

56. Tyler Cowen, Big business, A love letter to an American anti-hero, St Martins Press, 2019, Ch 3.
57. Brian Bell, John Van Reenen and Simone Pedemonte, CEO pay and the rise of relative performance contracts: a question of governance? Journal of the European Economics Association, 19 (5) 2021.
58. See for example evidence given by Alex Edmans to the House of Commons Business Energy and Industrial Strategy Committee, Inquiry into executive rewards: paying for success, HC 2018.
59. Paul Willman and Alexander Pepper, The role played by large firms in generating income inequality: UK FTSE 100 pay practices in the late twentieth and early twenty-first centuries, Economy and Society 49/4 2020.
60. Macroeconomic policy can also be an important factor. Quantitative easing, which has had the effect of boosting asset prices, is widely thought to have exacerbated wealth inequality.

equipped to find new jobs if their existing jobs disappear.[61]

How to balance the advantages of a dynamic, fast-changing economy, in which growth depends on shifting resources from low to high productivity sectors, against the need to provide job security for all citizens is a task for government, but one which needs the cooperation of companies. Initiatives in this area are more important in maintaining social stability and promoting support for the capitalist system than a reform of executive pay.

61. Jeffrey N. Gordon, Is corporate governance a first order cause of the current malaise? Journal of the British Academy, October 2019.

Conclusion

The Anglo-American capitalist system has imperfections, but the imperfections are not so fundamental or so irremediable as to justify abandoning one of its central features, that the people who run public companies are accountable to shareholders and that the maximisation of long-term shareholder value is the best measure of their performance. This does not mean that businesses are run for the benefit of shareholders to the exclusion of everyone else, nor does it prevent companies from having a purpose, usually linked to their business, which can inspire employees and lift their spirits in a way that "maximising shareholder value" does not.

Companies should cooperate with government in helping to solve social and economic problems; the social insurance scheme mentioned in the last section is one example. But governments should be wary about imposing on companies, or encouraging them voluntarily to take on, social obligations which are not related to their business and in which they have no comparative advantage.

The day-to-day job of managers is to provide products and services that people want to buy, and to do so as efficiently as possible. There is or should be a division of roles between government and business, with each side doing the things that they are qualified and empowered to do – accountable to voters in one case, to shareholders in the other.

The government has many responsibilities which are essential to the building of a fair and prosperous economy – designing an equitable tax and benefit system, investing in education, supporting basic scientific research, and much more. It also has a responsibility for creating and maintaining a business environment which promotes competition, guards against monopoly and encourages new entrants. A vigorous competition policy is an essential part of a well-functioning capitalist economy.

A current concern in the US is the apparent increase in industrial concentration, allowing dominant companies to enjoy higher profit margins and to charge higher prices.[62] This is attributed, in part, to the failure of the antitrust agencies to intervene when a dominant company acquires a smaller firm that might pose a competitive threat in the future; the issue is especially relevant to the big technology companies such as Amazon, Google, and Facebook.

The Biden administration is set on pursuing a tougher antitrust policy, although it must avoid putting too many obstacles in the way of acquisitions. Part of the strength of the US technology sector comes from young firms which grow rapidly for a few years but expect to be acquired

62. Thomas Philippon, The great reversal: how America gave up on free markets, Harvard 2019.

when they have established a technology that larger firms may be able to exploit more effectively.

Competition is the driving force of a successful capitalist economy, and governments must ensure that it is not undermined by powerful corporations, whether in the economic or the political sphere. Crony capitalism is a persistent danger, as is the threat of regulatory capture, whereby the people running regulatory agencies are too heavily influenced by the firms they are regulating. Any obstacles or disincentives that inhibit the growth of new entrants, arising from the taxation system or from regulation, must be removed.

Where governments and companies do share a common interest is in combating the unpopularity of capitalism, or at least in ensuring that the system is better understood. Anglo-American shareholder-based capitalism should not be seen either as a scapegoat for the world's ills or as a perfect system that is incapable of improvement. Some people, especially those who want to make the world a better place, think there is something deeply unattractive, perhaps evil, in the capitalist system. Such people are never likely to fall in love with capitalism, but it should be possible to persuade them that well-run investor-owned companies are not greedy or immoral, that profits earned in a competitive market are a measure of success, and that a system based on shareholder accountability is an effective means of making the whole of society richer.

£10.00
ISBN: 978-1-913459-89-5

Policy Exchange
8 – 10 Great George Street
Westminster
London SW1P 3AE

www.policyexchange.org.uk